

Internal Revenue Service

**memorandum**

TL-N-10639-91

CC:FS:P&SI/ESHATZ/crs

date: DEC 20 1991

to: District Counsel, Laguna Niguel  
Attn: Susan Hergenhan

from: Senior Technician Reviewer, Passthroughs and Special Industries  
(Field Service)

---

subject: [REDACTED] v. Commissioner  
Docket No. [REDACTED]  
TL-N-10639-91  
Shatz Sabin Laguna Niguel  
§ 6231(a)(1)(B)

This is in response to your request for field service advice.

ISSUES

1. Is the small partnership exception to TEFRA applicable to the facts presented?
2. If the exception does not apply, should the treatment of the carryover of the loss be governed by TEFRA or section 6214(b)?

CONCLUSIONS

1. Because the allocation of legal fees constitutes a special allocation for purposes of section 6231(a)(1)(B), the small partnership exception is not applicable. Therefore, the TEFRA provisions govern the audit and litigation of the transaction. Because the statutory notice procedures are not applicable, the portions of the statutory notice referring to the partnership items should be stricken and dismissed for lack of jurisdiction.
2. The net operating loss carryover amounts are properly treated as affected items to the extent that they are attributable to the partnership loss. However, despite the fact that the period with which to make a determination with respect to affected items has expired under section 6229, section 6214(b) permits the Service to compute the correct amount of the tax liability in the open carryforward years. Therefore, in this instance the Service is permitted to recompute the amount of the loss carryforward for [REDACTED] and [REDACTED] in arriving at a deficiency for those years.

009509

FACTS

Petitioners [REDACTED] were partners in [REDACTED], a partnership consisting of [REDACTED] partners. During the partnership's [REDACTED] tax year, petitioners paid \$[REDACTED] in legal fees on behalf of the partnership. On the partnership return, petitioners were allocated [REDACTED]% of the deduction for legal fees, as well as their pro rata portion of the partnership losses. As a result of the allocation, petitioners claimed a net operating loss which was carried back to [REDACTED] and [REDACTED].

On [REDACTED], the Service issued a statutory notice of deficiency to petitioners. In addition to disallowing certain deductions attributable to petitioners' investment in a subchapter S corporation, the notice disallowed a claimed partnership loss of \$[REDACTED] for [REDACTED], as well as the carryback of the loss for [REDACTED] and [REDACTED]. On [REDACTED], petitioners filed a petition with the Tax Court alleging that the Commissioner erred in applying the statutory notice procedures rather than TEFRA with respect to the disallowed partnership loss.

DISCUSSION

In your request for field service advice you have asked that we determine whether the small partnership exception is applicable in this case. Specifically, you have asked that we address whether the same share requirement is violated when legal fees are specially allocated to one partner. If the exception is applicable, then the issuance of the statutory notice of deficiency was proper. If not, then the TEFRA provisions provide the proper procedure.

Section 6231(a)(1)(B) provides an exception to the TEFRA partnership and audit litigation rules for partnerships qualifying as "small partnerships". 1/ In order to qualify for the exception a partnership must satisfy the requirements set forth in section 6231(a)(1)(B)(i):

- (1) ten or fewer partners:
- (2) each partner is a natural person (not a nonresident alien) or an estate; and
- (3) each partner's share of each partnership item is the same as his share of every other partnership item.

---

1/ Partnerships qualifying for the exception may nevertheless elect to apply the TEFRA provisions. I.R.C. § 6231(a)(1)(B)(ii).

The information submitted indicates that the partnership has ten partners and each partner is a natural person. However, based on the special allocation of the legal fees, you have concluded that the same share requirement is not satisfied. For the reasons discussed below, we concur with your conclusion and agree that the TEFRA procedures should have been followed in this case.

The same share requirement of the small partnership exception requires that each partner's share of each partnership item is the same as his share of every other item. The regulations provide that the same share requirement is satisfied if for all periods during the taxable year each partner's share of each of the partnership items is the same as his share of the other partnership items specified by the regulations.

The regulations provide one exception to the same share requirement. With respect to mandatory disproportionate allocations under section 704(c), or similar principles, and special basis adjustments pursuant to section 734, 743 and 754, the same share requirement is inapplicable. Temp. Treas. Reg. § 301.6231(a)(1)-1T(a)(3). Because these special allocations are required by the Code, the regulations provide that such allocations will not violate the same share requirement, thus permitting an otherwise qualified small partnership to take advantage of the exception.

The Tax Court considered the same share requirement in Z-Tron v. Commissioner, 91 T.C. 258 (1988), and Harrell v. Commissioner, 91 T.C. 242 (1988). In both cases the court applied a "bright line" test to the same share requirement, which requires that the Service need only look to the actual items reported on the return for the year in issue to determine if the same percentages are met for each partnership item. If only one item (losses) is reported for that year, there can be no violation of the same share requirement, despite the fact that the partnership agreement has potential for profits to be reported differently.

In this instance, both the partnership return and the K-1 reflect the special allocation of the legal fees to petitioners. Because the allocation does not fall within the category of special allocations permitted by the regulations, the allocation violates the same share rule. Therefore, the partnership is subject to TEFRA for the [REDACTED] tax year, and the portion of the statutory notice of deficiency regarding the partnership items should be stricken and dismissed for lack of jurisdiction.

We note that based on the information provided it appears that the time within which to adjust the [REDACTED] partnership loss under TEFRA has expired. Under section 6229(a) the period within which to assess any tax attributable to partnership or affected

items is the later of three years from the date the return was filed or the last day for filing such return. Because there is no indication that the period has been extended or suspended under section 6229 or that petitioners' partnership items have converted under section 6231, thus making a statutory notice appropriate if issued within one year of the conversion, the statute appears to have expired.

You have also requested that we provide guidance regarding the proper treatment of the portion of the net operating loss carried forward to [REDACTED] and [REDACTED]. In particular, you have asked that we determine whether the carryforward amount may be adjusted despite the fact that the year in which the loss arose, [REDACTED], is no longer open with respect to the partnership, and the one year period for assessing the tax attributable to the affected item has expired. For the reasons discussed below, we believe that the portion of the carrybacks attributable to the TEFRA loss may be recomputed in the open carryforward years, thus permitting the Service to include the recomputed carryback in the calculation of the taxpayer's deficiency for [REDACTED] and [REDACTED].

The information submitted indicates that a statutory notice of deficiency was issued disallowing the portion of the net operating loss carryforward attributable to the partnership loss for the [REDACTED] and [REDACTED] tax years. Under TEFRA, a partnership item is defined as any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that such item is more appropriately determined at the partnership level than at the partner level. I.R.C. § 6231(a)(3). Losses incurred by a partnership are clearly partnership items. An affected item is any item affected by a partnership item. I.R.C. § 6231(a)(5). Because the existence and amount of a net operating loss carryback or carryforward is affected by the existence and amount of a partnership item, i.e., a partnership loss, a net operating loss carryforward is an affected item.

This characterization is supported by the Tax Court's analysis of an investment tax credit loss carryback in Maxwell v. Commissioner, 87 T.C. 783 (1986): "...the amount of credit to be carried back is not a "partnership item" because a partnership does not take into account any carryback for any taxable year. Rather, the carryback is peculiar to each partner's own tax posture. The carryback is, however, an "affected item" since its existence or amount is "affected by" the investment tax credit that is a partnership item. Sec. 6231(a)(5)." Maxwell at 790. Similarly, a carryforward is not taken into account by the partnership but is instead an item unique to each partner and an item that is linked to a partnership item, a partnership loss.

It is important to note that the statutory definition of an affected item is not limited to an affected item that arises in

the same year as the partnership item to which it is connected. Instead, the definition extends to any item that is affected by a partnership item, regardless of the year in which the affected item is reported. Accordingly, the period for assessment of tax resulting from an affected item is generally governed by the period of assessment for the partnership item to which it is attributable. I.R.C. § 6229(a). In this instance, the portion of the net operating loss carryforward attributable to the partnership loss is properly classified as an affected item with respect to the partnership's [REDACTED] tax year, the year in which the loss giving rise to the carryforward arose. Under section 6229(a), the Service has three years from the date of filing the partnership return to assess any tax attributable to partnership items or affected items, unless the statute is extended or suspended. The partnership return in this instance was filed on [REDACTED]. Because it does not appear that the statute was extended or suspended, the period of limitations expired on [REDACTED]. Therefore, the Service is barred from making a determination with respect to the disallowance of the partnership loss, as well as a determination with respect to the portion of the net operating loss carryover attributable to the partnership loss.

Although the TEFRA provisions do not permit the Service to make a determination with respect to the partnership loss and its carryforward, section 6214(b) provides independent authority for recomputing the carryforward amounts in the open years. Section 6214(b) provides:

(b) JURISDICTION OVER OTHER YEARS AND QUARTERS-

The Tax Court in redetermining a deficiency of income tax for any taxable year ... shall consider such facts with relation to the taxes for other years... as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year has been overpaid or underpaid.

In construing the scope of section 6214(b), the Tax Court, in Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436, 440-441 (1974), aff'd without pub. op., 510 F.2d 970 (3rd Cir. 1975) stated:

Section 6214(b) says that we have no power to determine an overpayment or underpayment of tax for any year not in issue which would form the basis of a refund suit or an assessment of a deficiency. (citations omitted) It does not prevent us from computing, as distinguished from "determining", the correct tax liability for a

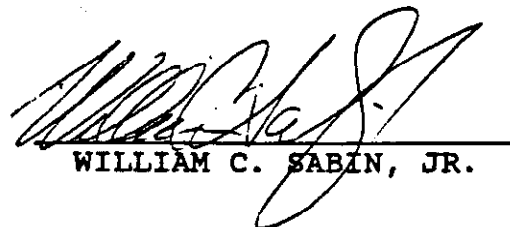
year not in issue when such a computation is necessary to a determination of the correct tax liability for a year that has not been placed in issue. (citation omitted and emphasis added)

See also Hill v. Commissioner, 95 T.C. 437 (1990).

Thus, under the authority granted by section 6214(b) the Service may, in [REDACTED] and [REDACTED], recompute the amount of the loss carryforward in calculating the taxpayer's deficiency in those years. However, the Service may not make a determination with respect to the partnership loss arising in [REDACTED] because the statute of limitations on the assessment and collection of partnership items has expired.

This document may include confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document should not be disclosed to anyone outside the IRS, including the taxpayer(s) involved, and its use within the IRS should be limited to those with a need to review the document in relation to the subject matter or the case discussed herein. This document also is tax information of the instant taxpayer which is subject to section 6103.

Should you have any question regarding this matter please contact Eileen Shatz at FTS 566-4369.



WILLIAM C. SABIN, JR.